PART I

TRENDS

WHY THE FUTURE BELONGS TO CHINA

CHAPTER 1

Sunrise in the East

CHINA BECOMES THE NEW WORLD SUPERPOWER

Success depends upon previous preparation, and without such preparation there is sure to be failure.

—Confucius

Wake up, world! China will have the world's largest economy within 10 years. That's a bold statement, but it's nevertheless absolutely true.

China's capitalist revolution officially started with a speech given three decades ago by the self-proclaimed supreme leader Deng Xiaoping. At the time, China's state-run economy was such a disaster that the government couldn't even feed its own people. Peasants were starving in the countryside.

Yet, for most Chinese people, the nation's decrepit state-run economy was the only system they had ever known. How could Deng Xiaoping drag China out of the economic dark ages and bring prosperity to the people . . . or at least provide enough food to fill their stomachs?

The year was 1978. A dramatic decision had been made in Beijing. China would scrap the communist principles that underpinned its economy and embrace U.S.-style capitalism. In his speech announcing this historic change of course, the supreme leader admitted China faced some serious economic problems. Then he said something utterly unexpected to kick-start the wheels of change in China:

> "To get rich is glorious!"

Coming from the leader at the pinnacle of China's Marxist-Leninist communist economy, Deng's proclamation was truly astounding. From a politician of lesser stature, those few words would have been political heresy and a likely shortcut to a death sentence.

But Deng didn't stop there. He went on to say that some people and some regions of the country would be allowed to get rich first. Chairman Mao would have turned in his grave if he had heard such a statement. Mao, the late Chinese ruler, had spent more than a quarter of a century in a determined effort to destroy the inequalities of the nation's political and economic elites. But instead of creating a nation of equals, the old China resulted in the world's largest social and economic disaster.

Now, less than two years after Mao's death, his successor, the new supreme leader, was calling for a different revolution . . . a *capitalist* revolution in the world's largest communist country! Long before Mikhail Gorbachev prodded the Soviet Union into *perestroika* and ultimate oblivion, Deng Xiaoping had realized that his nation needed a total industrial and economic transformation to prevent chaos and avoid the possible collapse of the Chinese state. He had to create an economic miracle.

To those who criticized Deng, his reply was quick and pragmatic. "Black cat, white cat, all that matters is that it can catch the mice," he said. With that simple, time-tested metaphor, China's new leader brusquely dismissed decades of Marxist-Leninist ideology. The most important things, he believed, were jobs and money to feed and house his destitute nation. If that meant some people got rich in the process, too bad for communist ideology. Deng was China's first new capitalist.

Who Wants to Be a Chinese Millionaire?

It is hard to grasp how far China has come in just three decades. Although it is still a communist country in name, China has created more than 300,000 millionaires[1] and 108 billionaires.[2] (If you include the billionaires who reside in Hong Kong, China has an amazing *150 billionaires . . . more billionaires than any country in the world except the United States.*) That old communist, Deng Xiaoping, has already been proven right. Getting gloriously rich has turned out to be a surprisingly real possibility in the new China.

China's new rich are becoming richer with unprecedented speed. In 1999, the *Hurun Report* ranked only 50 Chinese as being wealthy. During this time, the cutoff point to rank among the gloriously rich required a net worth of a mere $6 million.

Today, the list has been expanded to include an almost unbelievable 800 Chinese multimillionaires. What's more, the cutoff point on the new listing of China's wealthy class has been boosted to almost $100 million. Never before has so much personal wealth been created in just a short period of time. The survey quite rightly compares the booming Chinese economy and the nation's new economic landscape to the Industrial Revolution of the United Kingdom and the robber baron period of the United States, "when vast areas of the economy were wide open to be exploited by smart, ruthless and fast-moving entrepreneurs."[3] China's capitalist revolution is creating economic growth much faster and on a much larger scale than in either Britain or the United States.

Table 1.1 illustrates the extraordinary growth of wealth in China that took place in the twinkling of an eye—just eight years.

Table 1.1 Towering China Wealth

Year	Minimum Wealth to Qualify For China's "Rich List"	Number of People on List
1999	$6,000,000	50
2000	$42,000,000	50
2001	$60,000,000	100
2002	$84,000,000	100
2003	$110,000,000	100
2004	$150,000,000	100
2005	$60,000,000	400
2006	$100,000,000	500
2007	$105,000,000	800

Source: *Hurun Report,* hurun.net.

According to the *Hurun Report,* the 500 richest Chinese are now worth an average of 100,000,000 yuan, which is the equivalent of $276 million US!

The story of wealth creation in China is revealed in part by the sectors in which the nation's new rich have flourished. Table 1.2 demonstrates the sectors in which the Chinese have made their money.

As depicted in Table 1.2, the top of the heap for creating independent fortunes in China is in property development. Rupert Hoogewerf, CEO of the *Hurun Report,* says, "What stands China out from the rest of the world is that *China's entrepreneurs are all first generation*. There has been a revolution in China's attitude towards wealth." Indeed, many Chinese I have met are jealous of the new rich, but all aspire to become wealthy themselves. That's why millions of ordinary Chinese people open stock market accounts every year, driving the Shanghai and Shenzhen exchanges to record heights.

In the process of creating an entirely new wealthy class, China's burgeoning economy has transformed the countryside.

Table 1.2 Millionaires by Sector

Sector	Number of People	Percent in Sector
Property	220	24%
Manufacturing	205	22%
IT	73	8%
Healthcare	55	6%
Finance	47	5%
Services	44	5%
Iron and steel	41	4%
Retail	38	4%
Food and drink	36	4%
Energy	36	4%
Apparel	33	4%
Mining	31	3%
Chemicals	22	2%
Civil infrastructure	14	2%
Agriculture	12	1%
Oil and gas	9	1%
Media	6	1%

Source: *Hurun Report,* hurun.net.

Approximately 300 million desperately poor people have been lifted out of poverty. Moreover, the average person's income has been increased by 400 percent.[4]

Towering new cities have sprouted in empty fields to house China's growing middle class and their places of business. A never-ending flood of peasants are flocking into urban areas from the rural countryside in search of jobs and prosperity. This relocation movement is widely considered one of the greatest migrations in history and it is still going on. Although population estimates tend to be a bit unreliable, it is projected that 160 cities in China now have a population greater than one million. No other nation in the world has ever seen anything like it.

The Recipe for China's Urban Transformation and Economic Growth

Economic growth is the driver of China's urban transformation. From 1978 to 2006, the average growth of China's gross domestic product (GDP) has exceeded 9.6 percent every year[5] (see Table 1.3). The speed and steadiness of China's growth is unprecedented. So is the scale of this economic event, touching the lives of 1.3 billion people.

In 2006, China's economic growth rate was a world-beating 11.1 percent.[6] Compare that figure to the United States, which considers a 3 percent annual growth rate to be a sign of a thriving economy.

In labor-intensive industries, China has become the dominant manufacturer in the world. Chinese factories now make 70 percent of the world's toys, 60 percent of its bicycles, 50 percent of its shoes, and more than one-third of the world's luggage.[7] Among higher-technology products, China produces two-thirds of the world's photocopiers and microwave ovens, one-third of all DVD-ROM drives and desktop computers, and a quarter of the globe's TV sets and PDAs.[8]

It's no secret that Chinese factory workers earn an average of $5.00 a day or less.[9] For those who wonder when China's economic growth will run out of steam, the vast pool of available workers in the countryside provides a tangible answer. China will not run out of cheap labor anytime in the near future, not when hundreds of millions of people are waiting in line to take their place in China's growing and much-envied middle class.

Table 1.3 China's Trade with the World ($ billions)*

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Exports*	148.8	151.1	182.7	183.8	194.9	249.2	266.2	325.6	438.2	593.3	762	969.1
% Change	23	1.5	20.9	0.5	6.1	27.8	6.8	22.4	34.6	35.4	28.4	27.2
Imports	132.1	138.8	142.4	140.2	165.7	225.1	243.6	295.2	412.8	561.2	660	791.6
% Change	14.3	5.1	2.6	−1.5	18.2	35.8	8.2	21.2	39.8	36	17.6	20
Total	280.9	289.9	325.1	324	360.6	474.3	509.8	620.8	851	1,154.60	1,421.90	1,760.70
% Change	18.7	3.2	12.1	−0.4	11.3	31.5	7.5	21.8	37.1	35.7	23.2	23.8
Balance	16.7	12.3	40.3	43.5	29.2	24.1	22.5	30.4	25.5	32.1	102	177.5

*PRC exports reported on a FOB basis; imports on a CIF basis.
Source: PRC General Administration of Customs, *China's Customs Statistics;* and the National Bureau of Statistics.
Compiled by the US-China Business Council.

In China, workers cannot easily relocate from city to city to increase their salary because, under Chinese law, people are required to have a *hukou* to take a job in a city.[10] A hukou is an official pass that allows migrants to travel into a city. Some estimates, however, indicate that the Chinese labor pool includes a floating population of 100 million workers who are considered illegal immigrants. These laborers, who stream in from the countryside without a hukou, earn as little as a dollar a day.

Compare China's wage advantage to the United States, where ordinary factory workers earn an estimated $15 to $30 per hour and autoworkers can earn more than $50 per hour when benefits are included.

Critics blame the Chinese government for unfairly gaining a competitive advantage by manipulating its currency—that is, by keeping the Chinese yuan (also known as the *renminbi*) artificially cheap. Politicians in Washington accuse China of undervaluing its currency by as much as 40 percent, giving the nation's exports an unfair advantage over U.S. products. Turn on the evening news and you'll see a steady stream of pundits like Pat Buchanan and Lou Dobbs beat this drum. That's not enough of an advantage, of course, to make up for the huge wage disparity between the United States and China. There is much more to it than that.

The fact is, there are many, many countries around the world with rock-bottom labor costs, not just China. In the Far East, nations including Vietnam, the Philippines, Indonesia, and Bangladesh all vie hungrily for manufacturing jobs, offering labor at rates even lower than those offered by China.

As is evident by studying Mexico, an inexpensive and sometimes desperate labor force is no guarantee of economic growth. Despite its shared border, Mexico has fallen behind China as an exporter to the United States. The benefits of the North American Free Trade Agreement (NAFTA), physical proximity, and an abundant supply of cheap labor have not been enough to give Mexico an economic edge over China.

The main ingredient in China's stunning recipe for success is its cheap, determined, and highly dependable labor force. Here's another key to the Chinese economic miracle:

> China's workers are supported by a uniquely determined and well-organized government that is focused on one prime directive: to make the economy grow by any means possible.

China's highly motivated and organized workforce is supported by an equally motivated government. Beijing is actively building a vast, modern national infrastructure that has already succeeded in turning the once poverty-stricken nation into the world's factory floor. New roads, railways, airports, universities, and all of the tools that are required to build a modern economy are in place in the major cities and under construction throughout the country. This immense modernization project is part of a determined effort to make China a world leader and cement its place as an advanced society on the global stage. Beijing has no intention of losing its economic status to a lower-wage manufacturing nation. The United States serves as a sharp reminder of the importance of staying on the leading edge of infrastructure, education, and research and development.

From Rags to Riches

How has China grown to become the world's second largest trading nation, surpassing Germany and now challenging the United States?

To some degree, the credit goes to our old capitalist mentor, Deng Xiaoping. He did much more than proclaim a slogan about the glory of riches. He put his life and freedom at stake to create a modern economy in China. Even though he had been purged from government as a "capitalist roader" in 1966 and was put under house arrest 10 years later as a so-called *rightist,* Deng ultimately unleashed the capitalist spirit in China. Nationwide acceptance of capitalism is another key to China's growth.

By promoting a program called the "Four Modernizations," Deng set out to revamp agriculture, industry, science and technology, and education. In agriculture, Deng's reforms set farmers free economically by allowing them to keep the profits from crops they grew in excess of their government-mandated quotas. Markets suddenly appeared in thousands of villages as farmers sold their produce for cash. Private and collective enterprises appeared as peasants began manufacturing toys, fireworks, bricks, and clothing. Successful peasants became rich by Chinese standards and began building homes, sparking the creation of larger industries.

To help promote industry, Deng created special economic zones (SEZs) in the coastal provinces of Guangdong and Fujian. As he hoped, tax subsidies attracted Hong Kong's manufacturing tycoons, who set up large-scale manufacturing plants. The number of zones eventually multiplied and the program of tax incentives and grants was expanded, creating an industrial explosion along China's coastal regions. Meanwhile, moribund state-owned enterprises (SOEs) faced (for the first time) competition and the prospect of bankruptcy.

Science and technology in China had been severely disrupted by the Gang of Four's ill-conceived attack on the nation's schools and universities during the notorious Cultural Revolution. As part of the modernization effort, an emergency program was put in place to expand the education system. Admissions were allotted according to merit-based testing rather than by party affiliation.

In a remarkable display of pragmatism, hundreds of thousands of students were sent out of the country, even to the capitalist Mecca—the United States—in search of modern scientific and technical knowledge. They brought U.S. expertise and attitudes home with them. Today, Chinese universities turn out an estimated 352,000 engineers annually.[11]

The Market Opens

Deng Xiaoping also deserves substantial credit for legitimizing stock markets in China. While touring the special economic zone of Guangdong in 1992, Deng realized the power of capital investment. As he marveled at the economic boom underway in cities like Shenzhen, he responded to a question about equity markets. He said, in a famous quotation, "Are such things as securities and stock markets good or not? It is permitted to try them out, but it must be done in a *determined fashion*."[12]

It was one of Deng's last major pronouncements, and it unleashed a flurry of capitalism at home and abroad. The issuing of shares and trading of stock had been tried out in a tentative and poorly organized way for many years before Deng exhorted the nation to proceed in a "determined fashion."

After Deng's 1992 declaration, China's would-be capitalists took full advantage of their new freedom to get rich by trading in a growing pool of equities, not all of them legitimate. Stock markets flourished in mainland China, taking investors on a wild and volatile ride. Companies and brokerages appeared, soared, and sometimes disappeared. The two markets in Shanghai and Shenzhen now offer more than 1,800 listings and valuations are still highly volatile, when compared to Western standards.

The China Securities Regulatory Commission is engaged in an ongoing effort to root out corruption and bring stability to the nation's internal stock markets following a number of scandals and multiyear market crashes. Although many shady companies and dishonest brokerages have been put out of business, Shanghai and Shenzhen continue to be unstable and immature markets, driven more by individual speculators than by experienced institutional investors. Fortunately, the two mainland markets remain mostly off-limits to most foreign investors. Only a few large offshore institutions are permitted to trade in Shanghai and Shenzhen under the title of Qualified Foreign Institutional Investors (QFII).

Why is the regulation of China's internal stock markets a fortunate situation for U.S. investors? Because China's best companies were first listed overseas in New York and in the special economic zone of Hong Kong. That gives U.S. investors easy access to the best China has to offer. We have more access to quality Chinese companies than the Chinese people themselves.

Less than a year after Deng's determined pronouncement in favor of stock markets, a leading carmaker known as Brilliance China Automotive (CBA) was listed on the New York Stock Exchange, raising just $80 million in its initial public offering (IPO). Brilliance was listed as an ADR, an American Depositary Receipt. An ADR is a form of equity that represents ownership in the shares of a foreign company trading in U.S. financial markets, including the New York Stock Exchange and the NASDAQ.

Although U.S. investors were slow to warm up to ADRs from China, informed Chinese investors knew what a good deal the U.S. investment community was getting. Desperate for foreign capital, the Chinese government had listed only its so-called *National Champions* on overseas markets. Companies that earned the name National Champions included the biggest and most prestigious companies in the country, including vast state-owned enterprises that were undergoing capitalist reforms. To the frustration of China's would-be investors and the operators of the Shanghai and Shenzhen stock markets, the nation's biggest companies were not initially listed on mainland markets and some are still not.

Adr.com currently displays a total of 203 Chinese companies listed on U.S. exchanges (including Hong Kong–based firms).

Taking into account the Greater China region, another 108 Taiwanese firms are listed in the United States as ADRs. Many of the smaller, more speculative Chinese firms are listed on the NASDAQ. But the National Champions have emerged among the biggest firms on the NYSE by market cap. Five of the world's biggest companies (as measured by market capitalization) are now Chinese, compared to only three in the United States.

China's big five are China Life (LFC), PetroChina (PTR), China Mobile (CHL), Industrial and Commercial Bank of China (ICBC), and China Petroleum and Chemical (Sinopec) (SNP). The three U.S. firms still in the top 10 by market cap are ExxonMobil, General Electric, and Microsoft. Royal Dutch Shell of the Netherlands and Russia's Gazprom round out the list. (*Note:* Industrial and Commercial Bank is not listed in the United States.)

Chinese IPOs, especially those of Chinese banks floated on the Hong Kong market in 2007, have now joined the ranks of the largest IPOs in history. And Guangdong, the site of one of Deng Xiaoping's first special economic zones, has become the breeding ground for the greatest number of China's new millionaires.[13]

Expat Export Advantage

But there is much more to China's lightning-fast emergence as an economic superpower than the actions of one determined leader. China also had the advantage of an important base of knowledge and capital in Hong Kong, which had become a world financial and manufacturing capital during 155 years of British rule.

Advanced technical knowledge is being transferred from Taiwan, the breakaway Chinese province that had rebelled against the mainland in a sharp rejection of the communist revolution of Chairman Mao. As a free market economy, the island of Taiwan has become a world center for semiconductor manufacturing and a major investor in developing Chinese technology industries despite ongoing hostility between the two powers' governments. Expatriate Chinese communities in Singapore and Malaysia also contribute to China's emergence as a dynamically expanding economy.

The capitalist world has never seen anything like China's sudden economic expansion. The restructuring of the nation's economy and the resulting efficiency gains have contributed to a more than *tenfold* increase in GDP since 1978.[14]

Table 1.4 China's Top Imports 2006 ($ billion)*

Commodity Description	Volume	% Change*
Electrical machinery and equipment	219.0	25.3
Power generation equipment	109.2	13.4
Mineral fuel and oil	89.1	39.0
Optics and medical equipment	58.8	17.8
Plastics and articles thereof	37.8	13.6
Inorganic and organic chemicals	36.1	10.1
Ores, slag, and ash	32.2	23.6
Iron and steel	27.0	−15.4
Copper and articles thereof	17.2	33.3
Vehicles other than railway	17.0	38.4

*Percent change over 2005.
Source: PRC General Administration of Customs, China's Customs Statistics.
Compiled by the US-China Business Council.

Table 1.5 China's Top Exports 2006 ($ billion)*

Commodity Description	Volume	% Change*
Electrical machinery and equipment	227.4	32.0
Power generation equipment	186.6	24.7
Apparel	88.6	34.5
Iron and steel	51.9	52.2
Optics and medical equipment	32.6	28.0
Furniture	28.0	25.0
Inorganic and organic chemicals	23.2	21.5
Toys and games	22.6	18.4
Vehicles other than railway	22.4	34.8
Plastics and articles thereof	22.2	25.0

*Percent change over 2005.
Source: PRC General Administration of Customs, China's Customs Statistics.
Compiled by the US-China Business Council.

Exports are booming at an accelerating rate. China's trade surplus for the first six months of 2007 zoomed to a record $112.5 billion. The scale of China's expansion is so large that the statistics defy comprehension. For the month of June 2007 alone, exports were up by a breathtaking 85 percent over the previous year.[15] The nation's growth rate topped a stunning 11.9 percent that quarter. China's imports are also booming and would be headline news if exports weren't growing even more quickly (see Tables 1.4 and 1.5, respectively).

The Essential Consumer Class

The Chinese people are also beginning to embrace the new consumer culture. Retail sales are increasing at a rate of almost 18 percent per year, with total consumption for 2007 reaching above one trillion dollars.[16] The world's fastest-growing exporter is now the world's fastest-growing consumer market.

Newly wealthy Chinese consumers are snapping up automobiles and housing at record rates. Car sales rose by more than 34 percent in the first five months of 2007, despite an increase in taxes. House sales leapt by 27 percent in the same period, even though prices continued to climb.

One sure sign that people are feeling rich is an increase in travel, tourism, and dining out. Once again, the Chinese are posting sales increases in this luxury segment that would make any Western nation envious. Retail sales in lodging and catering rose by almost 19 percent in the first five months of 2007 to hit a new high of $12 billion. According to a report by the Credit Suisse bank, China's booming economy will boost it to second place behind the United States as the world's biggest consumer market by 2015.

China's appetite for the better things in life can sometimes seem surprising, considering that a recent survey[17] revealed that the average income for urban workers in Beijing was less than $4,600. The driving force behind the surge for luxury items is the capital's top wage earners who report much better earnings. High-level workers in the banking, securities, legal services, and petroleum exploration industries earned an average of $12,500 in 2006, a princely sum, considering the purchasing power of a dollar or its equivalent in Chinese yuan.

The Chinese Academy of Social Sciences conducted a three-year study and reported that as many as 240 million people have now joined the ranks of the nation's middle class. Just two decades ago, a mere eight million Chinese households were considered middle class. The academy defines the middle class as managers, professionals, skilled technicians, and service workers who earn between $2,500 to $10,000 a year.[18] There is still a great deal of room for growth. China won't be fully transformed from an agricultural society into an industrial economy before the year 2015, possibly not until 2021.[19] That is not all that far away.

In real terms, the income of China's middle class has grown faster than even Deng Xiaoping might have hoped when he first exhorted the nation to go ahead and get rich. The per capita income of urban residents rose from a miniscule 343 yuan (about $44) back in 1978, to an average of 11,759 yuan in 2006. The per capita income of farmers stood at 134 yuan in 1978 (about $17), growing to 3,587 yuan in 2006[20] (about $473, adjusted for inflation). Farmers still lag city dwellers by a wide margin, but millions have at least been lifted above starvation wages.

Who are these new Chinese? The blue uniform of Chairman Mao is long gone. So is the angry image of dissent in Tian'anmen Square. The Chinese middle class is now much like any other in the world: white collar, college-educated, and ambitious. Unemployment is still high, approaching 10 percent, and so the level of competition for a good job is fierce. Competition for jobs means workers tend to remain stable once they have found a position.

The government is scrambling to create new industries and new jobs for the millions of educated young people and migrant farmers who enter the workforce every year. Always worried about the specter of social unrest, the Chinese government has set itself the mind-boggling task of creating 10 million new jobs every year.

Because China enjoys a household savings rate of at least 30 percent,[21] the potential to invest China's capital pool in new industry and to expand internal consumption is still enormous. The nation's growing pool of wealth is transforming China's internal economy, and these changes influence our investment decisions.

A study by Grey Global Group of Beijing found that the members of the younger generation in China are very confident about their futures and driven to get ahead in the business world. Money and self-image are important to this new breed of Chinese consumer. They are willing to experiment by buying new gadgets and wearing trendy clothes. More than half say they need to take risks to be successful, and Grey Global interprets this finding as the emergence of a huge unmet demand for new trends from consumer product companies.[22]

As disposable income increases, we expect to see the pool of Internet subscribers within China to grow substantially. It is projected to reach 200 million by the end of the decade and may pass that milestone much sooner. We also expect the market for appliances, especially luxury appliances, to increase. And there is little doubt that demand for automobiles, oil, energy, cell phones, and housing will continue to rise exponentially as millions of Chinese migrate to the major cities and join the nation's capitalist revolution.

Rising Economy, Hidden Dragon

The statistics we read in the newspaper can be misleading in a country as large and diverse as China because they paper over the wide gap between urban wealth and rural poverty. On a national basis, China's gross domestic product (GDP) per capita was a relatively humble $1,800 in early 2007.[23] The average worker's income is expected to rise to $2,400 by 2010.[24] But this surprisingly low measure of individual wealth and productivity is distorted by the huge number of Chinese people who live in the countryside, many of them yearning for an opportunity to enjoy the prosperity of city dwellers. The World Bank estimates that 150 million Chinese still live in absolute poverty without adequate food or clothing.[25] But the Bank says the lot of the rural Chinese is improving, with an astounding 400 million people having been lifted out of poverty between 1985 and 2001.

A word of advice: Investors should always look at China's growth statistics with a jaded eye, but not because they tend to be overstated, as was usually the case with centrally planned economies like the now defunct Soviet Union. To the contrary, China's numbers are usually understated. Why? Because China prefers not to alarm the world or attract undue hostility from its trading partners with revelations about the scale of its economic expansion. As the always-quotable Deng Xiaoping once said, "China should disguise its ambition."

Here's a startling example. In early 2006, the Chinese government decided to take a deeper look at its recent economic growth statistics and concluded it had made an error, a very big one. Beijing bureaucrats suddenly discovered (or perhaps revealed) that the size of the economy had been underestimated by a whopping $280 billion. *That's billion, with a capital "B."* The revelation of China's new growth figures touched off the equivalent of an earthquake on the world's economic scene.

Many comfortable assumptions were shaken up badly. Observers in the European Union noted with particular alarm that China had suddenly replaced Italy as the world's sixth-largest economy. Europolitix.com worried aloud, "The Asian dragon now threatens the French number five ranking." Of course, both France and Italy have now been left in the dust by China's economic dragon.

Just how important was this discovery? The revision of China's 2006 economic growth estimates followed a one-year economic census that discovered the missing $280 billion in hidden economic output during 2005. To put it in perspective, the census result meant that China had discovered a new internal economy equal in size to the economies of entire countries. This previously unrecorded economy is on a par with the economies of Turkey or Indonesia.

The new economic numbers boosted China's gross domestic product for 2005 to almost $2 trillion, as measured by the conventional yardstick of nominal GDP (see Figure 1.1). That resulted in a colossal jump of 17 percent in the GDP from the previous year.

The new GDP numbers transformed our own understanding of the Chinese economy, and they made it a much more attractive investment arena. Previously, statistics were calculated from data provided by institutions such as large factories, a method left over from the days of the centrally planned communist economy. In China's increasingly market-based economy, these supply-side figures entirely missed the cash component of economic activity.

Supply-side economic numbers fail to take into account the amount of money that consumers *actually spend*. This ongoing accounting error has thoroughly distorted perceptions of the Chinese economy for decades and given economists countless sleepless nights. The new numbers reveal a picture of China that is far more balanced and hopeful than we had dared imagine. What has been revealed is a giant service economy within China. North Americans take the service economy for granted because so much of our economic activity is based on value-added services and knowledge-based products. It turns out that China is also fast becoming a player in this arena.

Fears that the Chinese economy was in a bubble, driven largely by excessive investment, have been eased considerably. This shows that the national economy is much more diversified and healthier than anyone had known.

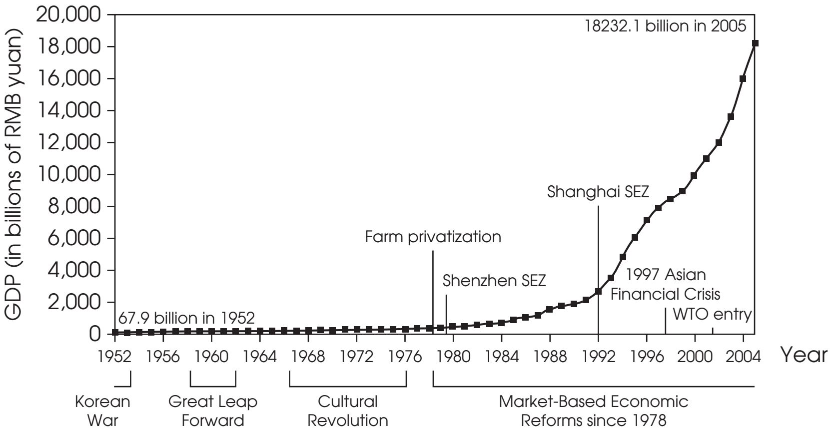

Figure 1.1 People's Republic of China's Nominal Gross Domestic Product (GDP) from 1952 to 2005
Source: billcara.com.

There may be more hidden economic activity to be revealed in China, adding to its already phenomenal growth profile. Dong Tao of Credit Suisse First Boston says that China may still be underestimating the size of its service sector by another $200 billion.

Who Is the World's Real Economic Superpower?

The shape of the world economy is changing so quickly that it will soon be unrecognizable to those who are not following the China story. It may seem that China still has a long way to go before it eclipses the United States's economy, which had a GDP of more than $13 trillion in 2006.[26] But the day is coming.

Conventional wisdom predicts that China will overtake the United States in 2035 in nominal GDP terms. But that prediction severely underestimates China's accelerating economic growth and the scale of its economic transformation.

The World Bank has an alternative and very credible way of measuring national economic output, the PPP method: *Purchasing Power Parity*. Many economists believe that PPP provides a more meaningful way of comparing economies than the usual nominal GDP figure. Here's what the World Bank figures tell us. As measured by Purchasing Power Parity, the Chinese economy is *already* the second largest on the planet, following only the United States.

This is a big shift in America's worldview and it calls for a few words of clarification. Purchasing Power Parity is a way of comparing the economies of countries without the distortions caused by currency exchange rates and other disparities. Rather than estimating GDP by national currencies, PPP calculations compare the average costs of goods and services between countries. Imagine, for example, that a factory worker in China has to pay much less for a new washing machine than his counterpart in the United States. The Chinese worker may be earning less than the U.S. worker in absolute dollar terms, but he may be richer than the raw numbers indicate because of his greater purchasing power for a given basket of goods and services. The World Bank and the Central Intelligence Agency (CIA) use PPP when comparing national economies.

By the standard of Purchasing Power Parity (PPP), China had a GDP of *$10.1 trillion* in 2006.[27] Compare that with America's GDP, estimated at $13.13 trillion, using the same PPP yardstick. China is very close and catching up quickly.

As I said at the beginning of this chapter, China is definitely on track at current growth rates to surpass the United States as the world's number one economic power within 10 years. In its "Eleventh Five-Year Plan, 2006–2010" the Chinese government set ambitious goals to transform the nation into a "well-off society" in the next 20 years and to *double* GDP in 10 years.[28]

China's growth affects the whole world and it has been a particular boon to its Asian neighbors. Roughly one-third of China's trade volume is conducted within the Asian region, amounting to approximately half a trillion dollars. This increased trade volume has allowed Asian nations to enjoy higher rates of growth than industrialized countries in the West.[29] Japan is one of the great beneficiaries of increased trade with China. The island nation is finally reporting GDP growth of more than 2.5 percent after years of stagnation, when growth barely touched the 1 percent mark.

Former Australian prime minister Paul Keating calls China the motor of the world economy.[30] Keating, who has also served as Australia's treasurer, calculates that China adds $400 billion to $500 billion worth of new wealth to the world's economy every year, an amount that has now surpassed the U.S. contribution to global wealth creation.

In Table 1.6, you'll notice that the United States ranks number one among China's trading partners. The United States' exports to

Table 1.6 China's Top Trading Partners, 2006 ($ billion)*

Rank	Country/Region	Volume	% Change*
1	United States	262.7	24.2
2	Japan	207.4	12.5
3	Hong Kong	166.2	21.6
4	South Korea	134.3	20.0
5	Taiwan	107.8	18.2
6	Germany	78.2	23.6
7	Singapore	40.9	23.3
8	Malaysia	37.1	20.9
9	The Netherlands	34.5	19.8
10	Russia	33.4	14.7

*Percent change over 2005.
Source: PRC General Administration of Customs, China's Customs Statistics.
Compiled by the US-China Business Council.

Table 1.7 China's Top Suppliers, 2006 ($ billion)*

Rank	Country/Region	Volume	% Change*
1	Japan	115.7	15.2
2	South Korea	89.8	16.9
3	Taiwan	87.1	16.6
4	United States	59.2	21.8
5	Germany	37.9	23.3
6	Malaysia	23.6	17.3
7	Australia	19.3	19.3
8	Thailand	18.0	28.4
9	Russia	17.7	37.3
10	Singapore	17.7	7.0

*Percent change over 2005.
Source: PRC General Administration of Customs, China's Customs Statistics.
Compiled by the US-China Business Council.

China are rising very quickly, up an average of 22 percent a year since China joined the World Trade Organization in 2006,[31] contributing to the sustained prosperity of the United States. And, while the United States may not be number one among countries exporting to China, the trend is still positive (see Table 1.7).

China's Biggest Import: Your Factories

One of the great mistakes made by U.S. politicians and television commentators is to focus angrily and exclusively on the downside of China's ballooning export surplus. But why blame China?

Here are the facts. Many of the factories that have been built in China in the past decade are the result of offshoring. Unlike outsourcing, offshoring involves the shifting of an entire corporation's production apparatus to the Chinese mainland to take advantage of low labor costs. According to Ma Kai, the minister of the powerful National Development and Reform Commission, China has received more foreign direct investments than any other country for 14 straight years. By the end of 2006, there were 590,000 foreign-invested firms in China.[32] This is unlike any economic event in history. More than half a million foreign firms have staked their place in China. Tens of thousands have uprooted their factories and voted with their feet by rebuilding manufacturing facilities inside China!

This is an astonishing economic migration. It is clear that the Chinese economic miracle has as much to do with offshoring by developed nations and foreign investment as any initiative sponsored by the Chinese. China's entry into the World Trade Organization in 2001 may have given foreign businesses comfort that they could operate in a stable legal structure. It was foreign firms, however, many of them Asian as well as from the United States, that are responsible for a massive shift of production facilities to China's mainland.

The consequences of the Chinese offshoring revolution are effectively a double-edged sword. Stephen Roach at Morgan Stanley estimates that more than half of America's whopping trade deficit with China results from offshore production.[33] Millions of U.S. workers have lost factory jobs to offshoring. Yet America's unemployment rate remains remarkably low. Clearly our economy is creating new jobs to fill the gap. What's more, economists at Morgan Stanley estimate that cheap imports from China have saved U.S. consumers $600 billion since the mid-1990s and provided a source of cheap parts to U.S. manufacturers.

The rise of Chinese consumerism may eventually begin to reduce the yawning trade imbalance that has struck so much fear into the hearts of U.S. economists. Chinese authorities acknowledge that their economy is far too dependent on exports. That's why news of increasing Chinese retail consumption and the development of an internal service economy is music to the ears of economic observers inside China and outside.

China's leaders want to build an economy that won't suddenly collapse if foreign demand for their exports begins to wane. As one Chinese diplomat told *The Economist,* "Imports, that's real diplomacy, because it means you're attractive to others. It means that other countries need you, not that you need them."[34]

By the same token, developed economies, the United States in particular, all desperately want China to consume more foreign goods and services. Thanks to China's ballooning trade surplus, it has become the world's largest holder of foreign exchange reserves. In a stunning development, China passed the one trillion dollar mark in foreign exchange holdings during the last quarter of 2006.

As if a trillion dollars of extra cash weren't enough, the flood of foreign currency continues to pour in at an accelerating rate. During the first half of 2007, another quarter of a trillion dollars was added to the nation's pool of foreign reserves.[35]

This unprecedented trove of wealth gives China immense power. Until 2006, most of China's foreign exchange surplus was simply invested in U.S. Treasuries and bonds issued by other industrialized nations. As every investor knows, U.S. Treasuries may be secure, but they do not pay a princely return.

When China passed the trillion dollar mark in foreign exchange assets, banking authorities decided they needed a better return on their holdings. Two hundred billion dollars has been carved out of the nation's foreign exchange reserve to invest in securities that offer higher returns and higher potential risk. How the Chinese decide to invest this block of money is the big question.

Interestingly, the first slice of China's foreign exchange, $3 billion, was invested in the private capital firm Blackstone. That money was rushed into the market to take a stake of the company before it launched its IPO. The remaining billions have the power to shake up stock markets. How ironic it is that a nation still run by the Communist Party has suddenly acquired the financial resources to reshape the world's capital markets. (As 2007 came to a close, Beijing decided to allocate a significant portion of this fund to bailing out ailing banks and to the provision of badly needed social services.)

Chinese tariffs and government-sanctioned protectionism are often blamed for the nation's huge trade imbalance with the United States. But that is far from the truth. China is actually twice as open to trade as the United States is and three times as open as Japan. According to C. Fred Bergsten, the highly respected director of the Peterson Institute for International Economics, China has been the fastest-growing market for U.S. exports for the last 15 years. Testifying before the Senate Finance Committee, Bergsten pointed out that U.S. exports to China grew by 160 percent between 2000 and 2005, while America's exports to the rest of the world rose by only 10 percent. China's ratio of imports to GDP has soared from 5 percent in 1978 to 30 percent in 2005.[36]

The United States is unlikely to become competitive with Chinese labor costs in the foreseeable future. That's why the United States must invent new services and knowledge-based products that will appeal to China's growing middle class.

Wise Words from the Guru

The United States remains a powerful innovator. China, however, has the potential to become a much bigger customer for U.S. innovation and become a powerful partner with our knowledge-based industries. Because China has a population of 1.3 billion people, we have not yet begun to experience its full potential. China is still at an early stage of development compared with the growth curve of other countries, including Japan, South Korea, and Taiwan. According to Carsten Holz, a professor of economics at Hong Kong University of Science and Technology, these countries all experienced a similar economic rise from poverty. Judging by the track records of Japan, South Korea, and Taiwan, it appears that China still has a lot of room to grow. Holz predicts that China's GDP (measured by purchasing power) will surpass the United States in 2010 and says it will continue growing rapidly until 2015.[37]

Because of China's economic transformation, the world is entering a new phase of economic development that will shake up every assumption about our world that has prevailed for the past century. There is simply no doubt that China will emerge as the world's largest economy. But China cannot achieve this goal without ongoing capitalist reform and investment.

As an unabashed capitalist, I see the emergence of China as an opportunity for investment. As an investor, I expect the Chinese economy to continue growing and I look forward to seeing my clients' and readers' investment dollars grow right along with them. I, for one, believe that nothing helps economies grow like enlightened capitalism. And, nothing returns profits to investors like well-informed capitalism.

The most populous country in the world is still in transition from communism to free market capitalism. As investors, you and I have the privilege of profiting from China's new capitalist revolution.